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Abstract

Customer loyalty awards received under a customer loyalty award programme have a monetary value which should be included in the gross income of taxpayers. If these awards are accumulated over a period of time and retained by the award giver, then interest should be earned on the value thereof and paid to the member of the programme.

In South Africa no provisions exist in legislation or practice notes regulating the taxation of these awards and general principles of taxation need to be applied. The decision of the *Brummeria Renaissance* case changed the tax landscape in South Africa as the right to receive interest-free loans has been recognised as a taxable right which should be valued and included in the gross income of a taxpayer. In accordance with this principle, the right to receive interest on accumulated customer loyalty awards would similarly be regarded as taxable with the resultant inclusion thereof in the gross income of a taxpayer.

The taxation of awards received under customer loyalty award programmes is inconsistently applied across jurisdictions and no provision is made for the taxation of interest earned on accumulated awards. Revenue authorities should review and amend tax legislation in order to provide clear guidelines for the taxation of customer loyalty awards and the interest earned on accumulated awards.

Keywords: taxation, customer loyalty awards, interest

Introduction

The development of customer loyalty award programmes (CLAPs) by companies brings another aspect of interest to the fore in South Africa that needs to be investigated for purposes of taxation. Individuals receive a rebate for interest earned on investments in South Africa and it only becomes taxable above a set threshold.

CLAs can be valued in monetary terms and they can therefore be included in the gross income of a taxpayer. The situation where CLAs are not used and accumulated needs further investigation in respect of the possible interest that could be earned by the customer on the capital amount of these awards held by the award giver vendor. The question needs to be addressed whether CLAs in this context can be regarded as a saving mechanism and whether interest, albeit on a notional basis, on the capital amount of the monetary value thereof should be included in the gross income of a taxpayer. It seems that interest on CLAs is not taxed at all since CLAs is not regarded as taxable income. At the speed of which CLAPs are growing and the magnitude of transactions involved, it is submitted that a review of the stance of revenue authorities regarding the taxation of CLAs is necessary.

Types of Customer Loyalty Award Programmes

Various types of CLAPs exist in the commercial sphere in South Africa. Some of them are accordingly discussed to illustrate how these programmes operate.

eBucks

eBucks is the leading multi-partner awards programme in South Africa. (eBucks, 2013). Various incentives are provided to customers using certain prescribed payment methods, such as payment by credit card and cheque (debit) card. Depending on the status of the customer, a certain percentage of all purchases made is refunded by way of an award in the form of eBucks. eBucks is a virtual currency with a monetary value which can be used by customers to buy goods and services online from third parties. It is even possible for customers to use their eBucks to refuel their motor vehicles at service stations. eBucks never expire and it is therefore possible to accumulate a substantial amount in money value over a period of time.

Clicks

Clicks is a retail company trading in pharmaceutical and household related products and it provides the option to their customers to become part of a club in terms of which loyalty awards is provided (Clicks, 2013). Once a member purchases any merchandise in a Clicks store, points are awarded which are then refunded by way of cash-back vouchers to clients. These vouchers are valid for

a certain period of time only (approximately 12 months) and the benefit is forfeited after expiry of the voucher.

Discovery

Discovery is a multi-faceted company providing health insurance, life insurance, short-term insurance and investment products amongst others. (Discovery, 2013). This company uses a CLAP called Vitality, which provides benefits to members of this programme by securing preferential rates and discounts for its members at various third party partners of the programme. It rewards its members for making healthier choices in everyday life, which includes points for visiting a gymnasium and the purchase of healthy foods. In addition, cash back payments are provided to members and in certain instances these cash back payments are doubled at the expense of Discovery if these payments are retained for the members in order to be used for future medical expenses or insurance excess payments.

South African Legislation and Case Law

A CLA is defined and acknowledged in the definition of a 'loyalty programme' in section 1 of the South African Consumer Protection Act 6 of 2008 (CPA). Section 35 of the CPA states that loyalty credits or awards constitute a legal medium of exchange and are as such fully recognised in terms of South African law. It is therefore strange that no further legislative provisions or regulations exist providing for the taxation of CLAs.

Interest earned on an investment is regarded as income and it is therefore taxable in South Africa as far as it exceeds a set threshold as determined annually by the Minister of Finance.[1] Interest earned below this threshold is specifically excluded from taxation. Interest incurred in the production of income could qualify for a deduction from gross income if the purpose of obtaining the capital on which interest is charged can be closely linked to the income-earning activities of the taxpayer. This is not relevant when assessing the tax affairs of individuals who obtain CLAs in their personal capacity, since they are not incurring the interest expense in any business activity. However, it becomes relevant where businesses take part in CLAPs.

Before the taxability of interest earned on accumulated CLAs can be considered, it needs to be ascertained whether these benefits are indeed taxable.

In order for benefits such as points or awards received under a CLAP to be taxable, they should fall within the definition of gross income in the ITA or any other provision specifically including the benefit in the taxable income of the taxpayer.

A benefit received under a CLAP will be included in the gross income of the recipient if the award can be regarded as 'an amount, in cash or otherwise,

[1]It has been proposed in the 2013/14 Budget Speech that a tax incentive in the form of tax free interest income is envisaged from April 2015 that will replace these thresholds.

received by or accrued to or in favour of'[1] the taxpayer. It has been held in *CIR v Butcher Bros*[2] and confirmed in *CIR v People's Stores (Walvis Bay)*[3] that an 'amount' includes any ascertainable money value and since it is possible to place a value on CLAs, they would therefore qualify as an 'amount'. The next aspect that needs to be confirmed, is whether such amount has been 'received by' or 'accrued to' the recipient. The earlier of receipt or accrual is used for timing purposes. Where a taxpayer is awarded CLAs in his personal capacity, the right to receive the CLA is received and accrual will accordingly take place. It is submitted that the point in time at which these benefits are redeemed should be irrelevant in light of the fact that the right thereto accrued to the taxpayer at the point in time when the CLAs were awarded to the recipient, subject to unconditional entitlement as laid out in *Ochberg v CIR*.[4] This is in contrast to the accounting treatment of CLAs and the provisions concerning forfeiture to which some CLAPs are subjected to in their terms and conditions. Legal certainty in this regard is required as far as the treatment for tax purposes is concerned.

In the case where an employer purchased airline tickets for its employee, the employee did not receive the CLAs for its own benefit, since the CLAs were in the first instance awarded to the employer purchasing the airline tickets (Spearman, 2011). In accordance with the principles laid down in *Geldenhuys v CIR*,[5] a benefit can only be taxed in the hands of the person receiving the benefit 'on his own behalf for his own benefit', and accordingly the employer will be taxed on the benefits and not the employee (Spearman, 2011). If the employer then awards the CLAs to the employee, the employee could possibly be taxed in terms of paragraph (c) or paragraph (i) of the definition of gross income as being connected to services rendered to the employer (Spearman, 2011). This would effectively result in the absurdity of double taxation. Other writers such as Pretorius (Pretorius, 2011) and Brink (Brink, 2012) are of the opinion that similarly to the legal position in Australia, the necessary *nexus* between a service rendered by an employee and its employer and the CLAs awarded is absent in the case where company credit cards are used to earn CLAs in the form of airmiles. In addition, the CLAs are not awarded by the employer or a related entity as required in terms of the Seventh Schedule to the ITA (Brink, 2012; Pretorius, 2011).

From the above explanation of the taxability of CLAs, it follows that interest received on accumulated CLAs that complies with the same provisions will similarly be included in the gross income of the recipient of the interest.[6] The question needs to be answered whether such interest will be regarded as

[1]As per the definition of 'gross income' in section 1 of the ITA.
[2]1945 AD 301.
[3]1990 (2) SA 353 (A).
[4]1933 CPD 256. Brink (Brink, 2012) holds a similar view.
[5]1947 (3) SA 256 (C).
[6]Provided the interest is received as income and subject to the provisions of sections 10(1)(h), 10(1)(hA) and 10(1)(i) of the ITA which deals with interest earned outside South Africa and by non-residents, which falls outside the scope of this discussion.

actual or notional in nature and whether or not that would have an influence on the taxability thereof. It is submitted that this should not influence the taxability thereof in light of the decision reached in *Commissioner, SARS v Brummeria Renaissance.*[1]

In this decision the Supreme Court of Appeal of South Africa held that the right to use interest-free loans constitutes gross income which accrued to a taxpayer.[2] Whether or not it had a money value was the primary question and in determining this an objective test was applied without considering whether the right could be turned into money.[3] This decision overturned the previous decision of *Stander v Commisioner for Inland Revenue*[4] where the ability to turn the right into money was presupposed for a donation to constitute 'property'.[5] The significance of the *Brummeria* case lies in the fact that a concept such as 'notional income'[6] was acknowledged and the fact that CLAs are not convertible into cash would not mean that those awards are not taxable.[7] The court held that the benefit the companies in question received of receiving loans without having to pay interest on them constituted a taxable benefit.[8] It is this taxable benefit, the monetary value of the interest not being charged in the transaction, that can be equated to the concept of notional income.[9] From this decision it is clear that the receiving of such a benefit is indeed taxable. Furthermore, interest earned on such a benefit, similar to the earning of interest on an investment, would have to be included in the gross income of a taxpayer.[10]

However, SARS does not treat benefits received under a CLAP as taxable in South Africa, whether in applying the general or the fringe benefit provisions of the ITA. Various writers have expressed their views on the

[1][2007] SCA 99.

[2]This case only relates to interest-free loans received in a *quid pro quo* situation and has subsequently been amplified with SARS Interpretation Note No. 58.

[3][2007] SCA 99 at par. 15.

[4]1997 (3) SA 617 (C).

[5]The concept 'property' is very widely defined in the ITA and includes any right in or to property whether it is movable, immovable, corporeal, incorporeal or wherever it is situated. It has been confirmed in cases such as *Lategan WH v CIR* 1926 CPD 69 that every form of property with a money value will be included in gross income.

[6]The concept 'notional income' is acknowledged and applied in Belgium (Belgium Federal Public Service Finance, 2012).

[7]The principles of this decision were subsequently applied to loyalty programmes in *Vacation Exchanges International v CSARS* 2009 JDR 0743 (WCC), 71 SATC 249.

[8][2007] SCA 99 at par. 20.

[9]A taxpayer is prohibited to claim a deduction for notional interest in terms of section 23(h) of the ITA. Notional interest in this sense refers to interest which could have been earned on capital which is instead applied in trade (Stiglingh, 2012). This explanation of interest does not refer to interest which should have been earned and to which a right existed, but in effect has not been paid by a business holding accumulated CLAs. This situation needs furthermore to be distinguished from retail discounts where only an expectation, a *spes,* to receive a reduction or discount from the sales price exist and not a clear right thereto.

[10]This corresponds with the provisions of section 24J(10) of the ITA which includes a payment or an amount or consideration otherwise than in cash for purposes of interest earned in respect of a period exceeding 12 months.

reasons for SARS not taxing these awards. Andoh argues that the providers of CLAPs are not associated institutions as defined in the Seventh Schedule to the ITA and Clegg argues that no taxable benefit arises and that the Seventh Schedule of the ITA does not make sufficient provision for the taxation thereof (Pretorius, 2010). This treatment of SARS of not levying any tax on CLAs is not unique since other jurisdictions, such as Australia, New Zealand and the United States of America (USA), also follow the practice of treating such benefits as non-taxable albeit under certain specific defined circumstances.

Certain CLA providers double the value of awards made to customers if those customers do not redeem the awards but retain the funds with the provider for the purpose of utilising those funds at a later stage for insurance excess payments. In terms of section 55(1) of the ITA, such a doubling of awards could amount to the gratuitous disposal of property, which would trigger donations tax for a person other than an individual on any amount donated within a 12 month period exceeding ZAR10 000 in aggregate, if no *quid pro quo* was involved.[1] In some instances awards expire after a period of time. If awards are regarded as 'benefits' and therefore 'property' (as per the *Brummeria* case), the expiration of these awards could amount to the renunciation of a right that could lead to a donations tax liability in terms of section 55(1) of the ITA, subject to the principle of unconditional entitlement. It could even qualify as a 'disposal' for Capital Gains Tax (CGT) purposes. In the event that a lower interest rate than that offered by commercial banks are paid on accumulated CLAs, donations tax could become payable on the difference provided that the transaction did not involve any *quid pro quo*. It could be argued that the business of the CLAP customer that is sought with the provision of CLAs represents the *quid pro quo* in the transaction and that any element of gratuity is therefore lacking, which will render the difference in interest rate being paid susceptible for inclusion in gross income as per the principles laid down in the *Brummeria* case.

It remains to be seen whether SARS would treat these transactions as donations in terms of the ITA. If no interest is paid to customers owning these accumulated funds, and with no concomitant tax liability for the entity 'saving' these funds on the basis that the funds are not held for the entity's own benefit, then surely a tax liability would arise at the point of releasing the funds.

The monetary value of CLAs is ascertainable. There is therefore no reason why it could not be included in the gross income of a taxpayer. Even if the value is not ascertainable, it is possible to make use of estimates to establish a fair market value in accordance with international accounting standards.[2] Specific valuation rules for these awards should be established in order to value the awards appropriately for tax purposes (Spearman, 2011).

It is important to consider whether the recipient of CLAs received ownership of the award before the award is redeemed. If there is a provision in

[1]Section 56(2)(a) of the ITA. No gratuity exists if the transaction involves a *quid pro quo* which will render donations tax inapplicable.

[2]IFRS (International Financial Reporting Standards) per IFRIC 13 Customer Loyalty Programmes.

the terms and conditions of the programme which does not offer ownership with the earning of awards before the award is redeemed, then the argument is made in the USA that the amount can not be taxed in the hands of the recipient (Prater, 2012). The notion of subjecting ownership of an object to the redeeming thereof from the party giving an award should be investigated further in the South African legal context, since it is possible to obtain other subjective rights and personal rights akin to usufructuary rights without receiving the *bare dominium* or full ownership of the underlying object.

Other Jurisdictions

Australia

The Australian Tax Office (ATO) and Australian courts[1] have held that awards received under CLAPs are not usually taxable and in this regard specific guidelines are provided in a practice statement (ATO, 2013).[2] From these guidelines it appears that the nature of the business relationship present is a determining factor. Due to administrative costs, only certain transactions will be scrutinised by the ATO, which includes contrived and artificial arrangements, awards received as substitution for income and points accumulated from a business relationship or business expenditure exceeding 250 000 points per year (ATO, 2008). There is no mentioning of the taxation of interest earned on accumulated awards, whether actual or notional.

Canada

The Canada Revenue Agency (CRA) does not tax employees for receiving CLAs such as airmiles on their credit cards in respect of travelling undertaken for business purposes, provided that the CLAs are not converted into cash, that they do not constitute any form of additional remuneration and that no tax avoidance is committed (CRA, 2012).

New Zealand

A product ruling[3] has been issued to Air New Zealand, effective from 1 April 2009 until 31 March 2014, which was made under section 91F of the New Zealand Tax Administration Act 1994 (New Zealand Inland Revenue, 2009). In terms of this ruling, no tax liability exists for either Air New Zealand issuing airmiles to customers or the recipient of air miles from Air New Zealand since no income is regarded to be realised in the transaction. The ruling is not binding on other CLAPs.

In another ruling[4] issued to Bank of New Zealand, effective from 23

[1]*Payne v Federal Commissioner of Taxation* (1996) 66 FCR 299, 96 ATC 4407, 1996 32 ATR 516.
[2]Law Administration Practice Statement PS LA 2004/4 (GA): Income tax and fringe benefits tax – rewards received under consumer loyalty programs.
[3]Product Ruling BR Prd 09/09.
[4]Product Ruling BR Prd 11/03.

September 2011 until 30 September 2014, the taxation of CLAs (called Fly Buys)[1] have been considered, specifically in relation to the investing by members in interest-bearing unit trust funds. Awards in the form of points are earned based on various criteria such as the balance in the account and re-investing, but these points are not converted into money and invested in the investment vehicles. This ruling excludes members receiving Fly Buys in the course of carrying on a business, which is similar to the treatment thereof in Australia. Awards expire after 36 months and can not be redeemed for cash. The ruling states that no income is received when points are received and that no interest or deemed interest arises when the member receives the points.

This is the only indication so far as to how revenue authorities would treat interest (or rather the non-existence thereof) on CLAs. Although this position is not supported, at least the existence of interest on CLAs has been recognised by a revenue authority.

United States of America

The Internal Revenue Service (IRS) of the USA regards CLAs which are not tied to the making of a purchase, such as a bonus received with the opening of an account, as a gift or premium that is taxable (Prater, 2012). Two customers of Citibank filed a class-action lawsuit after being held liable for taxation on the airline rewards received as part of a promotion to open a cheque account.[2] They accuse Citibank of unfair and deceptive trade practices for not fully disclosing the tax implications of the rewards and for inflating the value of the airline rewards, although the terms and conditions clearly state that customers are responsible for any personal tax liability. The case has not been finalised.

There is a difference between bonuses paid for opening a cheque account, which will attract income tax, and rewards connected with the use of credit cards, which are not taxable (Prater, 2012) and regarded as gifts, rebates or discounts (Hemsey, 2012). The difference between the two does not seem clear if the nature of the rewards is considered and the rationale behind this taxation principle in the USA should be questioned.

It is the opinion of tax experts that IRS rules have not kept up with the evolving nature of the rewards market since the last ruling in this regard was made in 2002 (Prater, 2012). It is clear that the nominal value of rewards at that stage did not warrant the administrative burden of taxing these awards. The landscape has clearly changed and tax experts are of the opinion that it is likely that the IRS will tax these awards in future (Hemsey, 2012). However, a telephone poll was conducted in February 2012 in the USA and 65% of participants indicated that they would cease using rewards cards if tax were imposed. Would this then not amount to killing the goose who lay the golden eggs anyway?

[1]Fly Buys is the largest customer loyalty awards programme in New Zealand.

[2]*Hirsch v Citibank N.A.*, No. 1:12-cv-01124 (S.D.N.Y., filed 2/14/12). This case has subsequently been filed in the Second Circuit Court of Appeals under case number 13-1172 on 1 April 2013.

Need for Reform

The world is changing constantly and especially as far as retail, marketing and payment methods are concerned. Where the concepts 'eCommerce' and 'mobiCommerce' were foreign to most people a few years ago, these concepts have now been replaced with the all encompassing concept of 'Universal Commerce', which is defined by Plozay of First Data as follows:

> *Universal Commerce is commerce that happens anytime, anywhere, and on any type of device. It blurs the lines between in-store commerce, eCommerce and mobile commerce such that many aspects of commercial activity are seamlessly integrated into one experience. From a consumer's perspective, shopping, payment, marketing (i.e., offers and coupons), loyalty, and money management all blend together in both offline and online experiences.*

This is specifically relevant in an era where smartphones and tablets are used to shop with electronic coupons and CLAs which in some instances can be transferred freely between third parties and co-account holders within the same family. More than 2 billion loyalty programme memberships exist in the USA alone and 10 million memberships exist in South Africa generating ZAR12 billion annually (First Data, 2012). Transactions of this magnitude can certainly not be ignored as an insignificant part of commerce. The evolution of traditional payment methods needs to be recognised by revenue authorities and the taxation thereof should be amended to keep up with recent trends.

Who would have thought that something so virtual as digital assets would form part of a deceased estate that could attract estate duty? Although this has not been specifically regulated in the USA, the IRS regards all property as forming part of the gross deceased estate and law firms include digital assets in estates for estate duty purposes where it is possible to place a value on loyalty points (Emery, 2013).

Despite indications by the Minister of Finance as far back as 1998 that CLAs would be reviewed (Pretorius, 2010), there are no specific provisions in legislation or guidelines stated in Interpretation Notes regulating the taxation of CLAPs in South Africa, except for some provisions concerning the VAT treatment of loyalty points in the gambling industry (SARS, 2007).[1] The need for reform in this regard is clear.

[1]SARS deems the provision of loyalty points, at the stage where the points are redeemed as loyalty points, as a prize awarded on the outcome of a supply contemplated in section 8(13) of the VAT Act. The awarder of the points will be able to obtain an input tax deduction of the VAT represented as a tax fraction of the money value of the points. The United Kingdom Supreme Court (*HMRC v Aimia Coalition Loyalty UK* [2013] UKSC 15) recently awarded an input tax credit on service fees relating to the processing of points on customers' loyalty cards to the operator of a loyalty award card scheme. If the courts and revenue authorities acknowledge input VAT credits on expenditure relating to CLAPs, the taxation of CLAs and interest earned on these awards should be acknowledged as well.

Conclusion

Benefits received under CLAPs can not be ignored anymore as miniscule, since the growth in monetary value thereof has lead to a significant taxable value for revenue authorities. The possibility exists that the taxation of these benefits could lead to a decline in the participating in CLAPs, but this fact in itself can not lead to a complete denial of the tax implications thereof. Should revenue authorities not be keen on taxing these benefits or the interest involved in accumulated CLAs, then tax legislation needs to be amended accordingly specifically exempting CLAs and any interest earned on these awards.

The endeavours of Treasury to promote savings in South Africa is appreciated and encouraged, especially in light of the proposed tax free interest income as of April 2015, but the taxability of CLAs and interest earned on these awards, especially after the *Brummeria* decision, can not be disregarded without proper guidelines and an amendment of the ITA to this effect. It is submitted that the current practice of SARS of not taxing these benefits in the absence of a specific legislative exclusion from the gross income of a taxpayer should be reviewed. Guidance should be provided in the form of proper regulation with a clear and practical approach of informing the taxpayer of the amount involved that should be declared for tax purposes, including a specific designation for CLAs on tax return documentation, should CLAs and interest received on these rewards be taxed in future.

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